Standard Life Investments
1 George Street
Edinburgh
EH2 2LL
www.standardlifeinvestments.com

Standard Life Investments

'Comply or explain': can it survive in a global market place?

5 June 2014

Presented by Guy R Jubb, Global Head of Governance & Stewardship at Standard Life Investments Ltd[1]

Mr Chairman, Ladies & Gentlemen,

I am reliably informed that there is a difference between a sermon and a lecture – and that is that at the end of one you might be enlightened and at the end of the other you might be asleep. As you know, this evening's lecture is all about comply or explain, so if anybody does nod off over the next twenty minutes I shall expect a very convincing explanation!

After my introductory remarks I should like to say a few words about the history of comply or explain as we know it today. I shall do so because one can become a veteran at a relatively young age in the field of governance and stewardship, and easily forget that there were many who were not around when Sir Adrian Cadbury and his Committee were getting to grips with the financial aspects of corporate governance. Then I should like to consider carefully the current state of play and, before concluding, I want to share some thoughts as to what the future may hold for comply or explain and its survival – its survival in a global market place.

In my line of business, I take nothing for granted and there are three questions that I want to pose at the outset because they are critical to the concept of comply or explain – past, present and future.

First, is comply or explain truly the foundation of good corporate governance or merely a fig leaf that masks the next crisis in our capital markets?

Second, is comply or explain a tool of accountability or merely a tool of transparency to enable boards to tick the box?

Third, do today's and tomorrow's institutional investors and stewards have both the competence, bearing in mind that many of them will never have sat in a board meeting, and the incentive to be good stewards and consider carefully the explanations provided?

These questions should be front of mind throughout our deliberations this evening.

---

[1] Disclaimer: The views expressed by Guy Jubb may or may not represent the views of Standard Life Investments, and are not those of the Public Company Accounting Oversight Board (Guy Jubb is a member of the PCAOB Standing Advisory Group).

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com

Standard Life Investments
1 George Street
Edinburgh
EH2 2LL
www.standardlifeinvestments.com

The History of Comply or Explain

Let me now say more about the history of comply or explain. Context is very, very important. I emphasise this because, as I shall demonstrate, the concept of comply or explain, was first developed in a very, very different context to the one in which we apply it today, which in turn will be very, very different to the context in which we shall apply it in twenty years' time. Context, ladies and gentlemen, is everything.

The genesis of comply or explain is to be found in the report of the Cadbury Committee which addressed the financial aspects of corporate governance. It is important to bear in mind that it was the financial aspects and not the broader aspects of corporate governance that were within its remit, since it is with the latter that we grapple today.

The Cadbury Committee's report was published on 1st December 1992. In setting the scene for the Report it was stated 'the country's economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines Britain's competitive position. They must be free to drive their companies forward but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance'.

That statement is as relevant and as important today as it was then. The words 'freedom within a framework of effective accountability' captures the true meaning of comply or explain. At the heart of the Committee's recommendations lay its Code of Best Practice which was 'designed to achieve the necessary high standards of corporate behaviour'. At the time the Report was published, the London Stock Exchange intended to require all listed companies, as a continuing obligation of listing, to state whether they are complying with the Code and to give reasons for any areas of non-compliance.

Furthermore, that the Committee stated 'our proposals aim to strengthen the unitary board system and increase its effectiveness, not to replace it. In law all directors are responsible for the stewardship of the company's assets'. I rather thought we had invented 'stewardship' after the last financial crisis – clearly not! And by the way, I should remind you, as Tomorrow's Company always does, that stewardship is a responsibility that is carried all the way along the chain that links savers to company directors. But more importantly it is interesting to reflect as to whether 'comply or explain' as embedded in Cadbury's proposals served to strengthen the unitary board system or undermine it as the burden of compliance grew topsy over time and moved our so-called unitary boards ever closer to being supervisory boards.

Also, the Committee expressed its belief that its approach 'with a voluntary code coupled with disclosure, will prove more effective than a statutory code'. I believe the vast majority of us here this evening would agree those sentiments but it is relevant to observe that whilst today's UK Corporate Governance Code may not be a statutory code, I think it would be fair to describe it as a regulatory code rather than a voluntary one. Arguably this is the destiny of many voluntary codes that are developed by leaders in the market place – they end up being underpinned in ways that make them mandatory.

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com

Interestingly, Cadbury's Code of Best Practice ran to only two pages, which is a marked contrast to the current UK Corporate Governance Code which comprises 30 pages. You will infer that the principles set out in the Cadbury Code were unashamedly high level ones and, although there were a number of accompanying recommendations, it was very much up to the board concerned as to how they applied these high level principles.

Reading the Cadbury Code one realises, on the one hand, just how far corporate governance has progressed and, on the other hand, just how complex we have now made it. That said, the principles set out in the Code have largely stood the test of time and are as applicable today as they were in 1992.

In its recommendations the Cadbury Committee said that listed companies 'should state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance'. Furthermore, the Committee said that it would 'leave it to boards to decide the terms in which they make their statement of compliance' noting that they are not expected to comment separately on each item of the Code. Also, that the statements of compliance should have been the subject of review by the auditors before publication. Importantly, the Committee said that individuals and companies 'are responsible for ensuring that their actions meet the spirit of the Code and in interpreting it they should give precedence to substance over form'. It is debateable whether these days the actions of individuals and companies are sometimes more geared to meeting the letter of the Code rather than its spirit. Preoccupation with 'the Compliance Syndrome 'prevails and can be addictive.

Last but not least, the Cadbury Committee recognised that there was an important role for the shareholders to play in holding boards to account. In this regard, it is worth emphasising that comply or explain merely provides a framework by which companies communicate. It only works as a conduit for good governance if shareholders and companies work hard to ensure it is used as an effective model for accountability. Indeed, the Cadbury Committee said that 'the issue for corporate governance is how to strengthen the accountability of boards of directors to shareholders'. It spent a couple of pages addressing the effectiveness of general meetings and it encouraged boards to experiment with ways of improving their links with shareholders, with a particular focus on annual general meetings describing them as ' an opportunity missed, because shareholders do not make the most of them'. Some things, for most institutional investors, have not changed.

The one thing that has changed is the shareholders themselves. They are very different today to the shareholders of yester year. For better or for worse, investment management and investment management techniques have become far more complex, far more sophisticated and far more technical since 1992. These and other factors have enabled index funds to flourish, have spawned high frequency trading and have opened the door to activists whose investment horizons and objectives may not be consistent with the long term success of the investee company. Back in 1992, mutual companies, who were both share owners and institutional investors, were prevalent and provided a back bone for genuinely long-term investment. There were many great mutual companies which have now been consigned to history – Scottish Amicable, Friends Provident, Norwich Union and Equitable Life – and even The Standard Life Assurance Company, which claimed to be Europe's largest mutual. It is relevant to note that these mutual companies did not have to

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com

address the agency issues arising between asset owners and asset managers that today can provide a barrier to effective investor stewardship. Rather, they were one and the same - and there was no stewardship code for shareholders to subscribe to. But the accountability of the mutual was weak – they were not held to account effectively by their members. The recent crisis at the Co-op underscores this view – in spades. Nevertheless, the capacity of mutual companies to take a genuinely long-term view – and invest accordingly – should not be under-estimated.

Following the Cadbury Code, codes became the fashion: a fashion that has stood the test of time. Comply or explain became the generally accepted norm for codes, enjoying the support of companies and investors alike because of the flexibility it affords. Also, it provides a good sound bite and it is hard to argue against comply or explain.

The series of codes that followed - the Cadbury Code, the Greenbury Code, the Hampel Code and then the Combined Code were all led by practitioners and enjoyed widespread support following widespread consultation. Codes provided an easy win for all concerned.

But as we entered the new millennium there was a notable shift. The practitioner led codes withered on the vine and were substituted with codes developed at the instigation of politicians and owned by regulators, notably the Financial Reporting Council – the FRC. Don't get me wrong, the FRC is widely respected and has successfully kept undue political influence at arm's length whilst always being sensitive to the public interest – long may this continue.

Today's Comply or Explain

So let's fast forward. Where are we today in comply or explain codeland?

The truth is that we're swamped with codes. And codes of varying calibre and purpose. We now have codes for remuneration consultants, for audit firms, and for proxy advisers - to name but three. The UK Corporate Governance Code and the UK Stewardship Code, which together will be the focus for the rest of this lecture, are undoubtedly in a class of their own. They are now embedded in the rhythm of business and investment, and subject to the discipline of a regular review by the FRC every two years. That is not to say that they are better codes than their less heavy weight counterparts. Indeed, their weight and density is such that there is a natural aversion – at least with the UK Corporate Governance Code - to add any additional provisions. To take things one step further, I believe there is an emerging case to start pruning it. The time has come to cut the clutter. As the FRC noted in 2011, 'All of those in regulating … annual reports have to change their behaviours if we are to remove clutter and improve the corporate reporting' and I'm afraid there are no honourable exceptions – even for the FRC! A purposeful prune would help to restore the primacy of principles and mitigate the risk of the Code becoming a rule book. And help to promote the use of comply or explain in a thoughtful and considered way.

The UK Stewardship Code has witnessed little change since it was first introduced. On one level, having obtained well over 250 signatories, the Code could be justifiably judged a success. On a

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com

Standard Life Investments
1 George Street
Edinburgh
EH2 2LL
www.standardlifeinvestments.com

different level, it is in need of some nurturing to bring back momentum to investor stewardship. A successful code is not dependent on only how many subscribe to it – rather on how it changes behaviours, and changes them for the good.

At Standard Life Investments, we are concerned that the improving trend of investor stewardship in recent years could be running out of steam. Earlier this year, in partnership with Tomorrow's Company, we published a report about how to build momentum for more effective investor stewardship[2]. One of the key recommendations is to make explicit in the UK Stewardship Code that investors should have a responsibility to contribute to the long term success of the companies in which they invest. We believe the FRC is sympathetic to this view and we hope that this will feature when the Code is reviewed in 2016.

Have codes become too easy to comply with? I believe that so far as the UK Stewardship Code is concerned, the answer is yes. Whilst I welcome the large number of investors who subscribe to it, I believe it has become too easy for investors to say that they comply with the Stewardship Code when in practice they merely comply with one small component of it - say, voting - but do not roll up their sleeves and get involved with the engagement and exercise of influence with investee companies that makes for good stewardship. Now that many asset owners insist that their asset managers comply with the UK Stewardship Code when awarding asset management mandates there is a commercial incentive to many asset managers to sign up to the Code so that they can tick the box and open the gate. I believe there is a risk that this state of affairs will, over time, undermine the credibility of the UK Stewardship Code. It is something that the FRC will need to carefully consider as it addresses the Code's future and ways to raise standards of investor stewardship. For example, it should consider whether the responsibilities of investment consultants come within its stewardship scope, and whether there is a role for stewardship accreditation, perhaps along the lines of the 'fair trade' symbol.

What Does the Future Hold for Comply or Explain?

Changes in capital markets have implications for how the UK Corporate Governance and UK Stewardship Codes operate. Since the financial crisis, there has been a continuing trend in investment portfolios towards risk diversification. As a consequence, they have now become more global, and the ownership of individual companies, especially the larger ones, has become more dispersed. The growth of sovereign wealth funds and changes to the UK pensions market have also played their part in contributing to increased global dispersion of ownership. These factors and others are leading to a dilution in domestic investors' stewardship. The trend is well-established and has potential consequences for accountability – or at least, the channels of accountability. The largest listed companies risk becoming accountable to everybody and accountable to nobody – and arguably this is already the case.

[2] Building the Momentum for Effective Investor Stewardship, Recommendations for Change, January 2014, published by Standard Life Investments & Tomorrow's Company

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com

Standard Life Investments
1 George Street
Edinburgh
EH2 2LL
www.standardlifeinvestments.com

In this respect, it is important to recognise the impact of increased intermediation on accountability. In particular, the importance of global proxy advisors should not be underestimated in respect of comply or explain. Will the global proxy advisors be the guardians of accountability in the future? The power of their voting recommendations is generally well recognised. It is often they – and not their clients, the institutional investors - who are expected to assess the quality of the explanation provided by companies. For many companies, compliance with the voting guidelines of ISS and Glass Lewis carries much more clout than compliance with the UK Corporate Governance Code itself.

In recent years there has been much debate about the quality of explanations provided under comply or explain. The FRC is doing good work to improve the quality of explanations. The implied concern is justified but it is only one of several soft spots that need to be considered. It is not only important to have a good quality explanation but it is also important to communicate it effectively. All too often the explanations are buried in the detail of the directors' report and they are ignored – or at least overlooked - by many investors when votes are cast at shareholder meetings. The incentive to companies is the contribution to a lower cost of equity capital as a consequence of governance risk and the management of governance risk being articulated and communicated effectively.

The Americans have introduced a useful 'proxy summary'. It provides a one-page snapshot of the corporate governance at a company and it refers the reader to the particular pages in the annual report where the relevant information can be found. This is something which UK companies should consider adopting – perhaps in the AGM notice. In respect of Code compliance, in particular, it would enable shareholders to discern at a glance whether or not the company has complied with the Code during the year in question and, if it does not it would point them directly to the explanation in the annual report. This, to my mind, is good communication.

A Question of Survival

Whilst focusing on improving the quality of disclosures is laudable, it is missing the big picture of the changing capital markets and the dilution in domestic investors' stewardship that goes with it.

It was Charles Darwin who first highlighted the need to adapt to change in order to survive. The same applies to codes. They need to adapt to change – and to changing global capital markets, in particular.

There are three key threats to the survival of comply or explain.

First, there is the threat of codes becoming rulebooks. Take the simple 'nine year rule' relating to the perceived independence of non-executive directors. This is not a rule – it is a principle, or at least a guideline. But it is increasingly treated as a rule, in part because it is easy for the proxy voting agencies to use this factual criterion as the basis for calling into question a director's independence - even if she or he is still very much independent in the way they fulfil their responsibilities.

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com

Standard Life Investments
1 George Street
Edinburgh
EH2 2LL
www.standardlifeinvestments.com

As an ever increasing proportion of UK listed companies is owned by overseas investors, who inherently are not as familiar as the domestic UK investors to our governance and stewardship conventions, it is, in my opinion, inevitable that an ever increasing proportion of the shares in UK listed companies will be voted in accordance with the recommendations of global proxy voting agencies. Global investors, owing only small amounts of the equity individually yet significant amounts in aggregate, have neither the resource nor incentive to challenge the agencies' recommendations.

The business models of many of the global proxy voting agencies are understandably built on the application of rules – not principles – in order to be scalable. The agencies interaction with their institutional investor clients goes some way to mitigating the risk consequences but be in no doubt that over time boards will increasingly place more importance on complying with the rules based voting guidelines of global voting agencies rather than the principles of the UK Corporate Governance Code.

Second, there is the threat of institutional shareholders becoming impotent. They may have the power but they don't have the incentive – and sometimes the responsibility - to use comply or explain as an effective basis of holding boards to account. Without strong shareholders, comply or explain will cease to provide a basis for accountability. Indeed, there is a risk of a false perception that they are an effective link in the chain of accountability when in practice they lack the incentive and mandate to go beyond the basics. This was a particular area of focus in our joint report with Tomorrow's Company, which made a number of practical recommendations to raise the stewardship bar from compliance to excellence. In this respect, I should like to commend the useful developments being undertaken by the National Association of Pension Funds to make asset managers think harder about their level of adherence to the Stewardship Code.

Third, is the threat is from politicians and regulators if boards and shareholders fail to exercise their rights and responsibilities of governance and ownership. If comply or explain does not adapt and the public interest – as well as shareholder interest – is damaged then it is only to be expected that politicians and regulators will fill the vacuum. And when politicians and regulators get involved, we shall move rapidly from principles to rules. Arguably, binding votes on the remuneration policy is an example of how the rules and regulations have sought to recognise the shortcomings of comply or explain in the field of executive pay. It has, at a stroke, removed the flexibility that was available to companies – or at least restricted it. But it has strengthened shareholder rights and provided a stronger basis of accountability than previously. The recent flurry of activity and political interest around the proposed Pfizer/Astra Zeneca takeover has enabled tensions to resurface about how boards and institutional shareholders fulfil their respective responsibilities and the importance of being able to determine with demonstrable conviction to whom is the board accountable to for its governance – past, present and future. In the future, will genuinely public interest companies be required to comply or explain with codes that embody the public interest? It feels like the direction of travel.

So what are the solutions to enable comply or explain to survive in a global market place?

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com

First of all, we need more effective accountability in respect of the explanations provided. One of the resolutions at UK AGMs which used to be called the 'nuclear button' is the resolution to approve the report and accounts. It was this resolution which traditionally used to be the focal point if there was a significant degree of shareholder unrest. A vote against this resolution used to send a powerful signal. Nowadays, although it is almost always the first resolution on the ballot card, it is passed without any notable dissent. It is, I believe, a legal requirement but in practice it has become an irrelevant resolution. So why not make it more relevant and useful? Why not make it a resolution to approve the comply or explain statement? This would ensure that the company's approach to comply or explain comes into the focus of shareholder accountability. It would not only force shareholders to give some thought to the explanation provided but it would also give boards the confidence that their approach enjoys the support of its shareholders – or otherwise.

Second, is to make investment managers more accountable to asset owners for how they evaluate the comply or explain statement and other aspects of stewardship. As was identified in the Tomorrow's Company and Standard Life Investments report that I mentioned previously, there is a need for asset owners to be far more challenging and enquiring of their investment managers as to how they have fulfil their stewardship responsibilities. There should be an explicit reference in the investment management agreement as to how asset owners expects the investment manager to fulfil its stewardship responsibilities, in general, and in relation to comply or explain, in particular. The chain of accountability in the chain of stewardship is only as strong as its weakest link – and the weakest link is the accountability of investment managers to asset owners. I wouldn't be surprised if the current review by the Law Commission of fiduciary responsibilities brings this into focus.

Third, is to harness technology and make AGMs a far better experience than is currently the case. Many companies and investors complain that AGMs are an expensive waste of time and money. In many respects, it is difficult to disagree. But to dispense with the AGM of itself would be a very retrograde step. Rather, we need to make the AGM more useful. We need to find a way that will enable shareholders in Sacramento, Sydney and Singapore to be able to vote and participate in AGMs in real time. This, combined with the suggested resolution that focuses on comply or explain – the quality of the explanation and its alignment with the best long-term interest of the shareholders - would bring comply or explain to life. Indeed, in the US, work has already been done on virtual AGMs.

To conclude, comply or explain has come a long way since The Cadbury Committee saw it as a means for shareholders and directors to have a conversation about the quality of corporate governance at the company concerned. It has adapted to change in order to survive but in doing so, comply or explain has become a tool of compliance rather than a means of encouraging the explanation of governance practices that best suit the company concerned. This is now coinciding with the convergence of more diverse share ownership, especially amongst the larger companies, a gradual erosion of domestic stewardship - and increased governance power vesting in the recommendations of voting agencies. I have put forward three ways in which we can adapt to change in order to help ensure comply or explain can survive in a global market place - a shareholder vote to approve the

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com

Standard Life Investments
1 George Street
Edinburgh
EH2 2LL
www.standardlifeinvestments.com

comply or explain statement, the strengthening of the stewardship chain, and bringing the AGM into the 21st century.

In the final analysis, comply or explain provides flexibility with accountability. If we do not use it, ladies and gentlemen, it is only a matter of time until we lose it.

Thank you for listening.

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com